Abstracting from temporary data aberrations, the US economy has maintained steady growth. European growth remains anaemic while Japan is staging a weak recovery after nearly four years of stagnation.

Continued technological innovation and further productivity gains have helped to keep inflation at bay. Job insecurity, leading to precautionary saving, continues to dampen demand in many OECD economies and prevent businesses from passing cost increases onto consumers. It has also dampened wage pressures.

Meanwhile, the need for fiscal restraint requires easier monetary policy to stimulate economic activity. Many European countries lowered their policy rates.

China's steady economic growth, modest easing of credit and progress towards current account convertibility will promote international trade flows, from which Hong Kong can benefit. The reduction of tariff rates and elimination of trade barriers in China should benefit foreign investors in the long term although the short term prospects are affected by the elimination of preferential treatment.

OECD Economies

Temporary government shutdowns and east coast bizzards depressed economic activity in the United States in January but there was a strong rebound in February. (Chart 1) For the March quarter as a whole, the US economy showed robust growth with real GDP rising by 0.7%. Consumer spending and equipment investment (especially on computers) were particularly strong. This may well continue into the June quarter as consumer confidence surged to a six-year high in April.

Employment grew by an average 166,000 jobs a month in the first four months of 1996, compared with a monthly average of 144,000 in 1995. The unemployment rate fell back to 5.4% in April; lower rates have not been seen since 1990. Employment, output and survey data all show that the services sector has been performing much more strongly than the manufacturing sector.

The German economy remains feeble despite rounds of interest rate cuts and the announcement of a package of measures which included extra financing for industry and reductions in both business and personal taxes. The economy weakened further in the final quarter of last year, with real GDP falling 0.4% – the first decline in two years. The most stunning component in the GDP contraction was the plunge in inventory, wiping out 1.2% from the quarterly GDP growth. While total investment was weak, partly due to the weather related drop in construction activity, consumer spending showed remarkable resilience. The contribution from net trade in the quarter was also larger than expected as a result of a huge fall in imports.

The sluggish economy has resulted in a pickup in unemployment, with the jobless rate for pan-Germany rising to 10.5% in April. Firms are generally reluctant to hire extra workers as the strength of the DM casts doubts over the durability of the recovery. There is as yet no sign of an end to the destocking process. Production is weak and business confidence continues to deteriorate.

The 1995 budget deficit came in at 3.6% of GDP, in excess of the 3.0% Maastricht target. Accompanied by the modest depreciation of the DM, a stable price outlook and some tax concessions in 1996, lower German interest rates should help to pull the economy out of the doldrums.

Chart 1
US Indicators of Activity (Jan 1995=100)

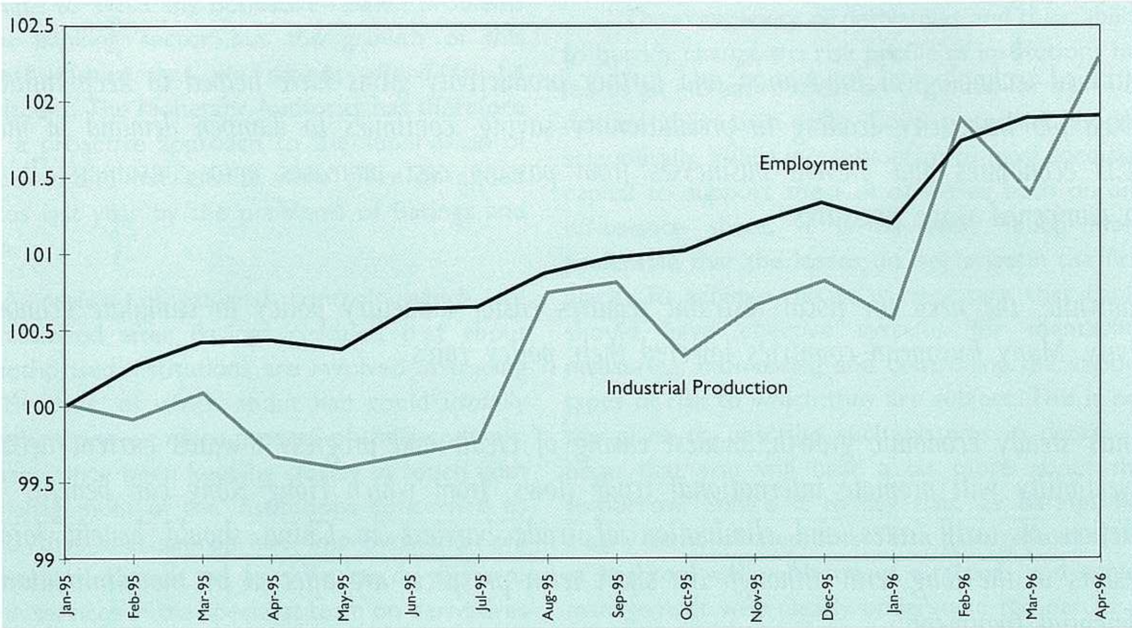
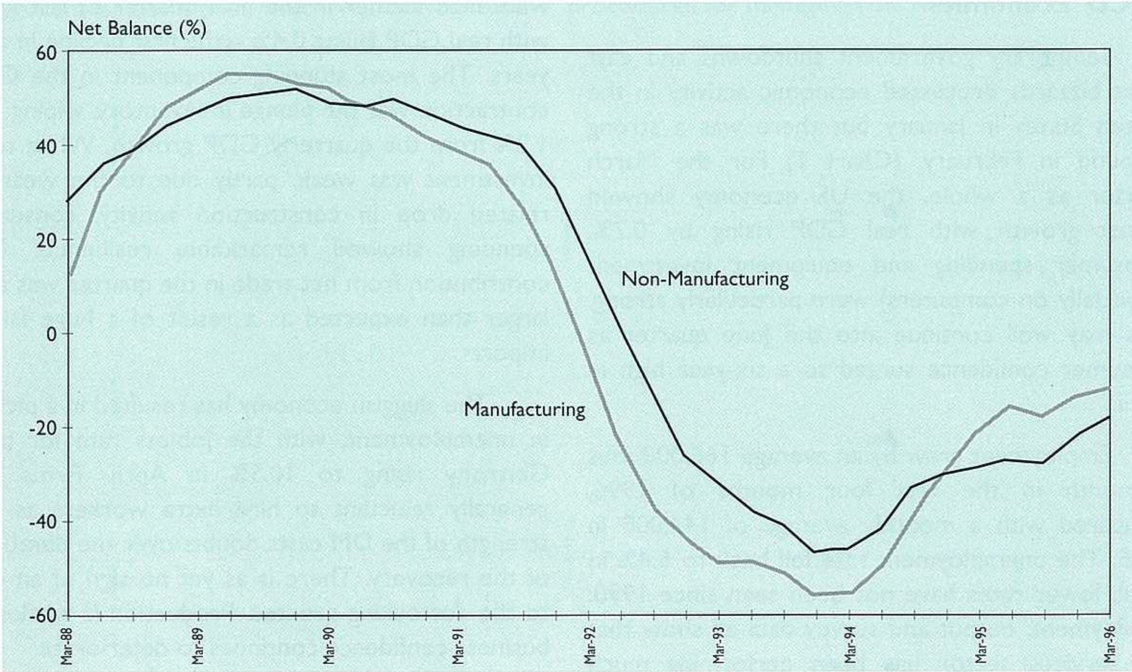


Chart 2
Japan Tankan Survey of Business Sentiment



There is increasing evidence that Japan has passed the worst of the economic downturn. Attributed to a pickup in domestic demand, real GDP rose 0.9% in the December quarter, the fastest pace in five years. This compares to 0.6% in the previous two quarters when growth was boosted by reconstruction after the Kobe earthquake. The government spending from the record 14.2 trillion yen public works package announced last September underpinned much of the advance.

There are other signs that the economy is strengthening. The index of leading indicators has risen markedly since June. The BoJ's *Tankan* survey in February showed business confidence continuing to improve, albeit very slowly (Chart 2). Consumer spending remains sluggish, hit by low wage increases and record unemployment.

Inflation

Inflation remains subdued virtually throughout the OECD. In the US the underlying CPI has been running at annual rates of around 3% since mid-1994. In Germany inflation is down to 1.5% and in Japan, it is non-existent. Most forecasters are confident it will remain low (Table 1).

Some commodity prices, notably oil and wheat, surged in early 1996, reflecting mainly temporary factors such as a severe winter in Europe and parts of North America. The gold price also moved up sharply. Some of these rises have now been partially reversed. Other commodity prices such as base metal prices remained largely steady, suggesting underlying inflationary pressure is not increasing significantly.

Monetary Policies

Accommodative monetary policy is currently the norm among the industrialised countries, most of which have lowered policy rates to stimulate economic growth (Chart 3).

The Fed lowered the funds rate and the discount rate during the January FOMC meeting, both by 0.25%, notwithstanding the ongoing budget imbroglio, and then left the rates unchanged at the

Table 1:
Forecasts of Consumer Price Inflation

		US	Japan	Germany
1995	– actual	2.8	-0.1	1.8
1996	– Consensus forecasts	2.8	0.1	1.7
	– Economist poll	2.9	0.0	1.6
	– IMF	2.6	0.4	1.5
	– OECD	2.1	-0.3	2.0
1997	– Consensus forecasts	3.0	1.3	2.1
	– Economist poll	3.1	1.1	2.0
	– IMF	3.0	1.3	1.5
	– OECD	2.4	0.7	2.2

Sources: Consensus forecasts February/March 1996 as reported in JP Morgan *World Financial Markets* Second Quarter 1996; *Economist* 11 May 1996; IMF *World Economic Outlook* May 1996; OECD *Economic Outlook* December 1995.

Chart 3
Policy Interest Rates

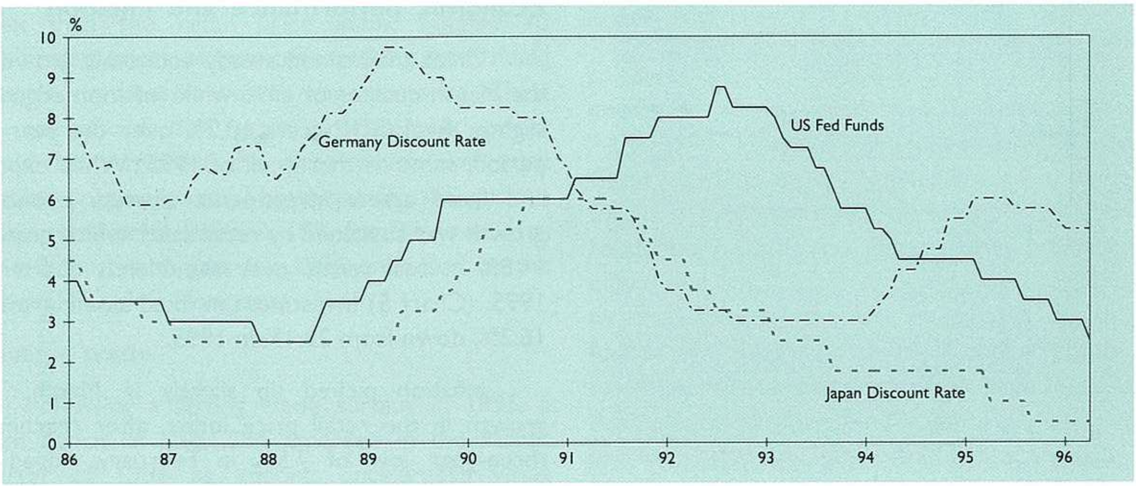
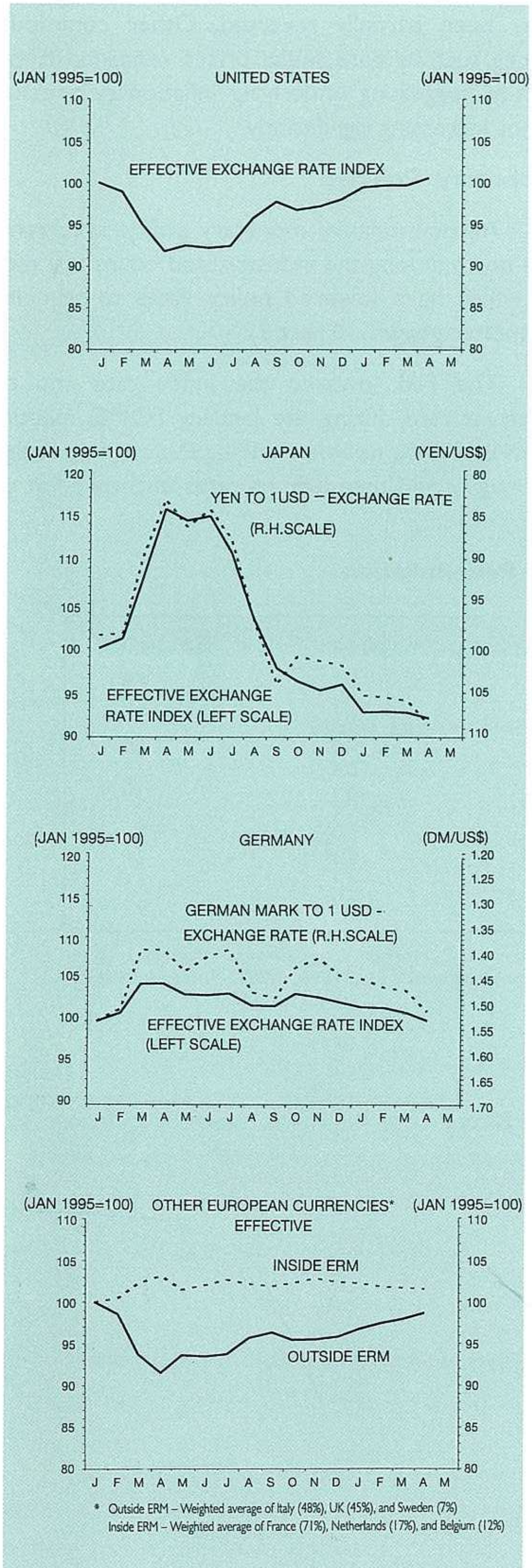


Chart 4
Exchange Rates



* Outside ERM – Weighted average of Italy (48%), UK (45%), and Sweden (7%)
Inside ERM – Weighted average of France (71%), Netherlands (17%), and Belgium (12%)

March meeting. The FOMC minutes for the meeting on 19 December threw some light on the minor role the budget debate has played in Fed policy making; members noted that "the fiscal drag imposed by likely federal budget developments would not be unusually large over the next few years".

In Japan monetary policy is expected to remain accommodative given the absence of inflationary pressures and the fragility of the banking system. Market speculation of an imminent rise in Japanese interest rates, triggered by misinterpreted comments from Finance Minister Kubo about the burden of low yields on elderly people dependent on interest income, was misplaced. The BoJ has continued to hold overnight rates in the 0.4%-0.5% target range maintained since last September.

In Germany the discount and Lombard rates were both lowered by 0.5% in April, with many other European countries following.

Financial Markets

The dollar continued to appreciate early in the year while both the yen and those European countries inside the ERM depreciated in trade-weighted terms (Chart 4). In general, exchange rate movements were much smaller and better aligned with fundamentals than in much of 1995.

Long bond yields rose in most major markets in early 1996. The rise was more pronounced in the US.

China

Economic performance and inflation

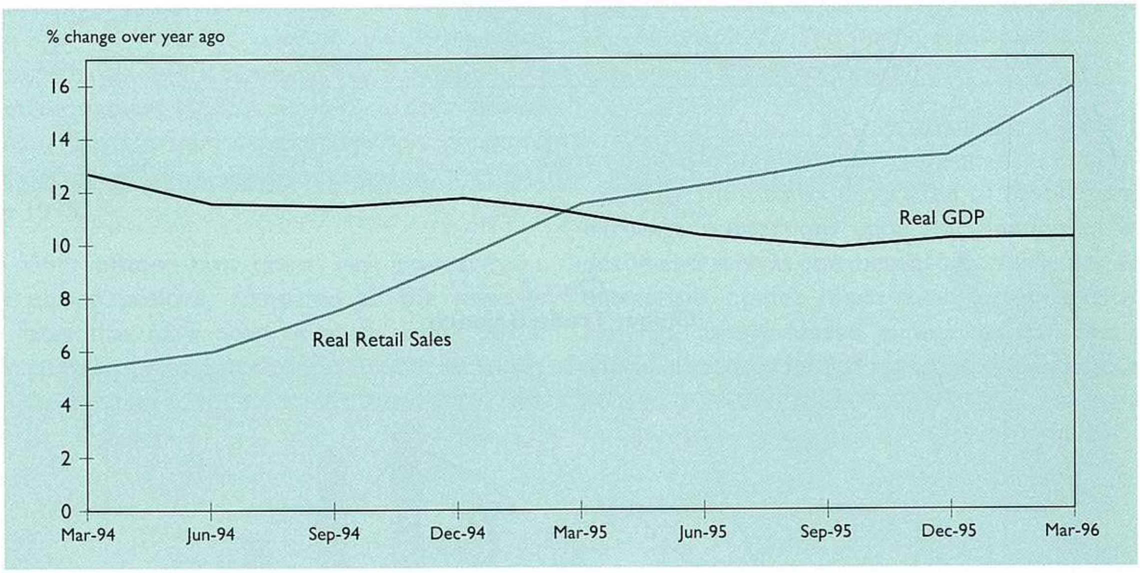
China maintained steady economic growth in the March quarter of 1996 while inflation edged up slightly. Real GDP grew 10.2% over the year-ago period, same as that in all of 1995. While exports and fixed assets investments slowed, economic growth was sustained by retail sales, which grew by 14.8% in real terms over the March quarter of 1995. (Chart 5) Investment in fixed assets grew by 16.2%, down from 22.1% in 1995.

Inflation picked up slightly in March. The growth in the retail price index, after reaching a three-year low of 7.5% in February, edged up slightly to 7.7% in March. The pick-up was mainly

Table 2:
Economic Indicators of China

	1995	1996 target	1996-2000 target
Real GDP growth	10.2%	8%	8%
Fixed asset investment as % of GDP	33.7%	32%	30%
Retail price inflation	14.8%	10%	<8%
Trade value	US$281bn	US$281bn	US$400bn (in year 2000)
Fiscal balance	-Rmb 62.1bn	-Rmb 61.4bn	To be balanced in year 2000
M2 growth	29.5%	25%	n.a.

Chart 5
China: Real GDP and Retail Sales



due to a faster rise in food prices (Chart 6). The cost-of-living index, which covered prices of both services and commodities, rose by 9.4% in the March quarter. The faster increase in cost-of-living index than the retail price index pointed to accelerated prices of services resulting from rising demand for them as well as wage pressure. China has announced that grain procurement prices would be increased this year which will push inflation up somewhat. The target for the growth in the retail price index is 10% for the year. (see Table 2 for the targets for 1996 endorsed by the National People's Congress).

Foreign trade

Following a strong trade surplus in 1995, a trade deficit of US$1.2bn emerged in the March quarter of 1996 as imports accelerated while exports continued to slow (Chart 7). Imports were boosted in the first quarter as joint ventures and foreign funded enterprises rushed to import capital machinery before the abolition of the tax exemption on 1 April 1996.

The short term outlook for imports is difficult to assess due to a number of reforms. The average tariff rate was lowered to 23% from 36% on 1 April 1996. However, the effective tariff rate in China was already very low (estimated to be below 5% in 1995) so it is uncertain how far the reduction in tariff rates will stimulate imports. The effect of a cut in tariff rates may be counteracted by the lifting of the tax exemption on foreign funded enterprises' imports of capital goods and raw materials. In addition, China announced on 1 April a quota-tariff system for imports of agricultural products such as grain and wheat, which had previously been directly controlled by the

Chart 6
China: Retail Price Index

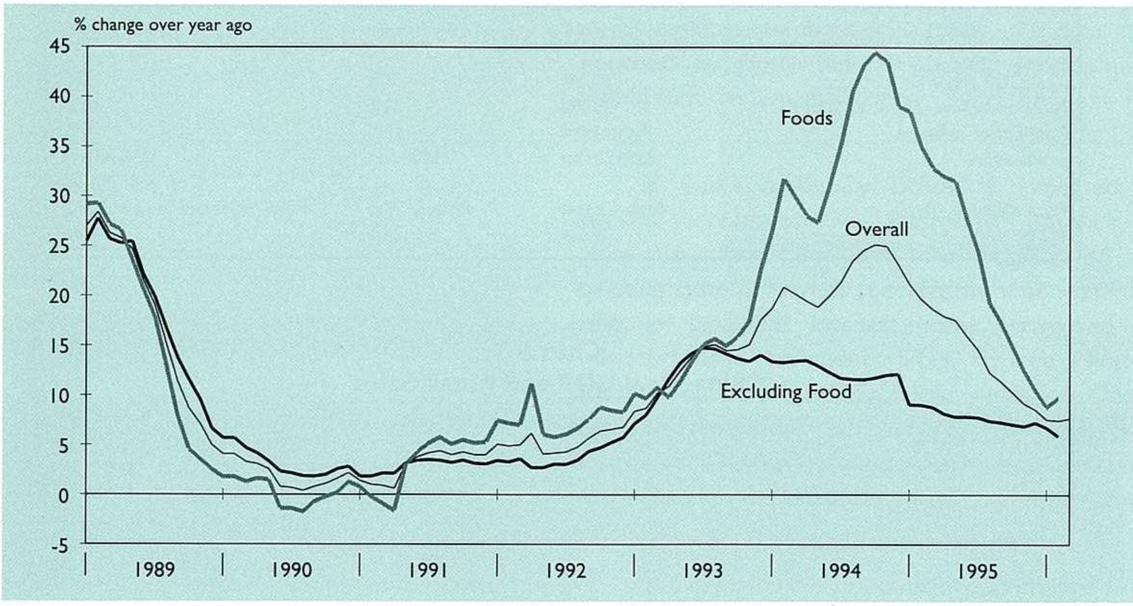
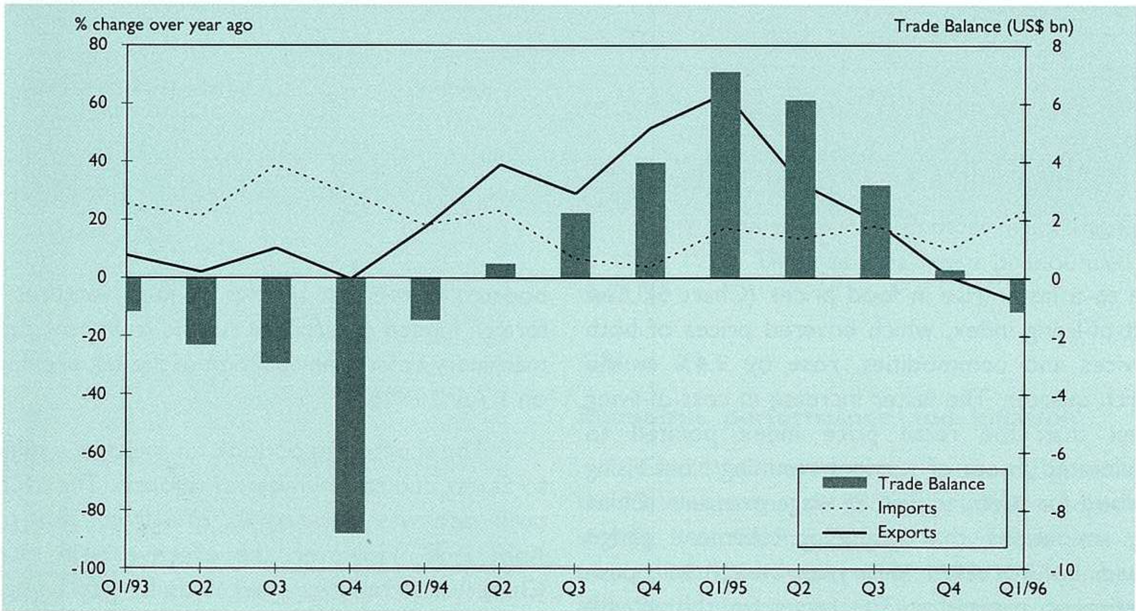


Chart 7
China: Trade Balance



government. While a modest tariff rate will apply to imports within the quota, those in excess are subject to a very high rate.

China's exports decelerated throughout the second half of last year and the trend continued into the beginning of 1996. This was partly due to rushed shipments before the cut in value-added tax rebate from 14% to 9% in January.

Domestic inflation, coupled with the appreciated renminbi last year, would likely add pressure on export growth in the first half of this year. The State Economic and Trade Commission forecast a surplus of US$5.5-6 bn this year, down from US$16.7 bn last year.

Exchange rate and monetary policy

The renminbi exchange rate remained steady against the US dollar in the first quarter of 1996 at around RMB 8.3/USD, after the appreciation since the swap rate and the official rate unified at RMB 8.7/USD at the beginning of 1994. In trade-weighted terms the RMB appreciated by 0.9% during the March quarter because of the stronger US dollar (Chart 8).

The RMB is likely to stay relatively stable in the near term. Monetary policy is being kept generally firm, but with selective easing to direct credit towards agriculture, the thousand key state-owned enterprises, and "pillar industries" (i.e. electric power, transport, telecommunications, steel, petrochemicals and chemicals). Broad money is targeted to grow by 25% in 1996, a little slower than in 1995. The scale of state bank loans is set at RMB 650 bn in 1996, slightly more than RMB 640 bn in 1995.

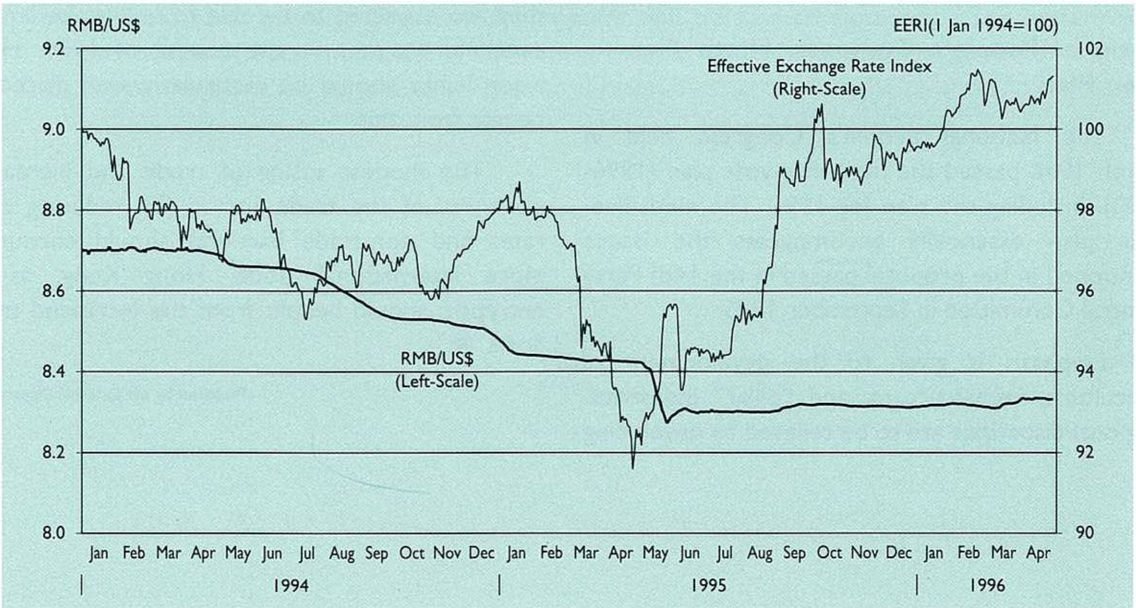
With inflation now lower, real interest rates have turned positive, compared to the negative real rates that have been usual in recent years. Under these circumstances, interest rate subsidies (a form of indexation) have not applied to new deposits accepted on or after 1 April. Interest rates were cut on 1 May; the average rate paid by banks on deposits was lowered by almost 1 percentage point and that charged on loans by an average of 0.75 percentage points. Given the authorities' concern over inflation, a more generalised easing in credit is not anticipated this year.

Current account convertibility and financial sector reforms

As a step closer to current account convertibility, the PBoC announced on 1 March 1996 a pilot scheme whereby foreign funded enterprises in four cities or provinces are no longer restricted to converting currencies through the swap market. The four localities are Shanghai, Shenzhen, Dalian and Jiangsu.

Foreign funded enterprises in these areas, like domestic enterprises, can now purchase foreign exchange from banks designated to handle foreign exchange transactions upon presentation of valid documents such as commercial bills. While domestic enterprises cannot retain their foreign exchange earnings, foreign-funded enterprises can retain a limited amount of foreign exchange in their accounts. Foreign banks in these four localities can handle foreign exchange transactions against renminbi.

Chart 8
China: Exchange Rate



Source: HKMA calculations based on data from Datastream.

The increasing ease of foreign-funded enterprises in converting currencies should enhance international trade with China. It should also promote foreign investment in the longer term, although there may be some short-term slowing as preferential treatment for foreign-funded enterprises is phased out.

The central bank recently allowed foreign banks to open sub-branches in Shanghai, Tianjin, Guangzhou, and Dalian. Previously, foreign banks had been restricted to opening only one branch in a city. The increased opening of banking business to foreign banks, through enhancing competition in the banking sector, can stimulate domestic banks in improving efficiency.

The People's Bank of China commenced open market operations in April. Short-term treasury bills are traded to influence liquidity. By the end of March, short-term treasury bills issued amounted to nearly RMB 90 bn. The volume of tradable bills will gradually increase so as to enhance the effectiveness of the operations. This is a significant move towards indirect control of money supply but for some time yet the central bank will mainly rely on direct tools to conduct monetary policy, including mainly the control of bank interest rates and the credit plan. In addition, the national interbank market, after three months of experimentation, came into full operation on 1 April. The interbank interest rates are allowed to fluctuate within a certain limit. This paves the way for the liberalisation of interest rates.

National People's Congress: Ninth Five-year Plan

The National People's Congress held in March 1996 passed the ninth five-year plan (1996-2000), including the plan for 1996. The ninth five-year plan essentially encompasses the issues mentioned in the proposal passed in the 14th Party Central Committee in September 1995.

Emphasis is given to the development of agriculture, infrastructure, and "pillar" industries. Regional disparities are to be relieved by developing central and western areas. Measures will be taken to reduce the debt burden on 1,000 key state-owned enterprises. Investment processes will also be reformed to define clearly investors for different nature of projects, the mode of fund-raising and responsibilities of project owners.

To open up the trade sector further, non-trade barriers will be gradually reduced. The tariff rate will be further lowered to the level of developing countries of 15%. Foreign investment will be directed to infrastructure development and technology transformation. To level the playing field between domestic and foreign enterprises, preferential treatment of foreign enterprises will be gradually phased out (Further details are given in Box A).

Effects on Hong Kong

Ongoing growth in the US and recovery in Japan, low inflation and more stable exchange rates, all bode well for growth in international trade. This will underpin economic activity in Hong Kong. Based on US economic conditions, large moves in US short-term interest rates, which would pass through into Hong Kong rates, are unlikely.

China's bid to make the renminbi more convertible will make it easier for Hong Kong companies to convert domestic receipts into HK dollars for remittance. In a related connection, foreign banks in China are also slated to benefit as they are expected to be able to undertake limited renminbi business in the course of 1996. Hong Kong banks should be particularly well placed to benefit from this.

The modest easing of credit and increasing openness of the trade sector (by reducing tariff rates and non-trade barriers) should encourage more international trade. Hong Kong, as an entrepôt, should benefit from the increased trade flows.

– Prepared by the External Department

Box A

Ninth five-year plan (1996-2000)

The five-year plan comprises the following major elements –

1. On development of industries, particular emphasis will be given to agriculture, infrastructure, "pillar industries" (i.e. machinery, electronics, petrochemicals, automobile and construction), textiles and tertiary industries.

2. Policies will be adopted to develop the central and western regions with an aim of reducing regional inequalities. These include prioritising resources for developing infrastructure, rationalising the prices of agricultural and raw material output of these areas, increasing financial support from fiscal transfers, policy loans and foreign official loans, encouraging investment in labour intensive industries from coastal regions, and attracting foreign investment.

3. In the reform of state-owned enterprises, focus will be given to rejuvenating a thousand large scale enterprises which contributed to nearly three-quarters of the total income from state-owned enterprises. In order to alleviate the burden of the heavily indebted enterprises, exemption of interest payment, delayed interest payment and delayed principal repayment of enterprises undergoing merger or acquisition are cited. The swapping of debt into equity and write-off of debt are also mentioned.

4. The investment system will be reformed. Three types of projects are identified – "competitive" ones where corporate investors are the responsible entities and shall raise funds from the market, "infrastructural" ones for which the central government is responsible for gathering funds, and "community" ones developed by the local governments. A system defining the responsibilities and equity requirement of the entity-in-charge of each project will be introduced.

5. Reform of the social security system will be accelerated. The system will cover pension, unemployment assistance, medical insurance and so on.

6. To continue the opening of the domestic sector, foreign investment will be allowed in areas of energy, transportation, finance, insurance, commerce, trade and other service sectors. In respect of foreign trade, the tariff rate will be further lowered to the level of developing countries and non-tariff trade barriers will be reduced. "National treatment" will be gradually applied to foreign enterprises. Also, quota-tariff system for imports will be further expanded. (The system will allocate quotas of a commodity for which enterprises can import under normal tariff rate; imports exceeding the quota are subject to a higher tariff rate).